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SECRETARY GUTIERREZ

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To Secretary Gutierrez from Ambassador William Taylor

11. (SBU) Summary: Your visit to Ukraine comes as the fragile two-vote majority coalition struggles to move ahead with an ambitious agenda as dissension between the two parties increases. All eyes are on whether Prime Minister Tymoshenko and President Yushchenko can work together better than they did in 2005 when Tymoshenko was dismissed after seven months of infighting; in the past few weeks, their relationship has become particularly strained amid mutual recriminations that the other is trying to sabotage the government's work. Nevertheless, Yushchenko and Tymoshenko have made numerous public statements noting that the orange coalition will remain in place. Both are also working separately on amending the constitution, which has become a key political issue. Economic growth is likely to remain strong this year, but inflation has surged and inflationary expectations are growing rapidly. Although Ukraine on May 16 joined the WTO, it still has a long way to go to improve its business climate. The energy sector is still marked by corruption and mismanagement, and is badly in need of new investment. Nearly all policy makers agree that Ukraine needs to modernize the sector and diversify its sources of energy, yet no government has been able to develop and implement a coherent long-term strategy to achieve this goal. Recent moves by the GOU to undercut its only Production Sharing Agreement (PSA), with the U.S. company Vanco, are causing some to question whether the GOU is sincere about attracting foreign investment to develop domestic energy resources. End summary.

Major Parties Already Focusing on Presidential Elections  
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12. (SBU) Although all three main political parties in the Rada (parliament) advocate similar approaches to economic reform and a foreign policy that calls for greater integration into Europe, their main focus is on the presidential election, now less than two years away, which has prevented them from cooperating on many issues. After the January disclosure of a secret letter requesting a Membership Action Plan from NATO signed by the President, Prime Minister, and Rada (Parliament) Speaker, opposition Party of Regions used the NATO issue as a pretext to block the Rada's work for most of February and pander to their Eastern Ukrainian electorate which is suspicious of closer ties with NATO. A political compromise was finally reached on March 6 and the Rada returned to work. Now, infighting within the ruling coalition between the Prime Minister's

faction BYuT and the President's faction Our Ukraine-People's Self Defense (OU-PSD) has once again derailed the Rada's work. The Rada majority has managed to pass a few laws, often with help from minority parties, but a new, more sustainable compromise is needed to pass key legislation, such as needed budget amendments and remaining WTO-related bills.

#### A New Government Starts Quickly, Then Stalls

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¶3. (SBU) Pre-term elections in September 2007, held to end months of political stalemate, saw Tymoshenko's BYuT faction pick up a large number of seats, leading to a new coalition and establishment of a new Government. PM Tymoshenko hit the ground running after her December 18 confirmation; she got a budget passed in eight days, completed her government program for the upcoming year, which was sent to the Rada for approval, and made some progress in fulfilling campaign promises, such as to return lost savings from the defunct Soviet-era state savings bank. In forming the coalition, BYuT and Our Ukraine split the government portfolios evenly, resulting in the surprise election of Yushchenko loyalist Arseniy Yatsenyuk, then the 33-year old Foreign Minister, as Speaker of the Rada in mid-December.

¶4. (SBU) Yushchenko and Tymoshenko's historically rocky relationship and mutual distrust between their parties have raised questions about the long-term stability of their coalition. In recent weeks, Yushchenko and Tymoshenko have been attacking each other publicly, eventually leading Tymoshenko's BYuT to blockade the Rada session hall.

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Nevertheless, both insist there is no alternative to the current coalition. The coalition managed to pass the budget, but has since failed to get its 228 (out of 450) MPs into their seats for several key votes, leaving a number of bills and nominations hanging. Both Tymoshenko and Yushchenko have reached out to Yanukovich, the former prime minister and now leader of the opposition, but thus far his Party of Regions has not been a constructive opposition. The Rada spent the final two weeks of January and most of February hamstrung as Regions blockaded the rostrum following the public disclosure of the letter requesting a MAP for Ukraine at the Bucharest Summit. Since then, infighting within the coalition over personnel changes and legislative priorities has produced a parliament that is only sporadically productive. All parties are looking ahead to the next presidential elections in late 2009/early 2010, and calculating their alliances and their policy views accordingly.

#### Economy Growing, but Inflation on the Rise

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¶5. (SBU) Ukraine's economy remains buoyant despite ongoing political turmoil. Real GDP growth was 7.2 percent in 2007, and is expected to reach between 5.5 and 6.5 percent this year. However, inflation is now at close to 20 percent, with April's inflation figures (note: nominally 30 percent April 07 to April 08, but distorted by low April 07 figures.) marking a ten-year high. Rapid income growth has caused a surge in imports and a widening of the current account deficit. The central bank has accumulated ample foreign exchange reserves to defend the currency, and is now allowing the currency to strengthen in an attempt to combat inflation. The outlook for the economy remains positive as incomes are still growing and Ukrainian companies are investing heavily to modernize their productive capacity. A major drop in world steel and chemical prices, contagion from the worldwide credit crisis and/or runaway inflation now pose the main risks to the economy in the mid-term.

¶6. (SBU) In their public rhetoric, the country's top politicians all promise pro-business regulatory reforms and advocate integration into the world economic system. The

actual pace of economic reform remains slow, however, and political leaders have resorted to administrative measures, such as restricting exports of sunflower oil, to combat rising food prices. The investment climate remains challenging, with the World Bank recently ranking Ukraine 139th out of 178 countries as a place to do business. The Overseas Private Investment Corporation (OPIC) remains closed to Ukraine because of the government's failure to settle a claim arising out of an expropriation in the 1990s. In spite of these challenges some movement on economic reform is discernible. The GOU is currently negotiating with the USG over the conditions for OPIC's return to Ukraine, and the country became the 152nd member of the WTO on May 16. Unfortunately, that historic moment was marred by Ukraine's failure to fulfill key WTO commitments, including passing the law that would lower its import duties upon accession to levels promised during the accession process, because of the political deadlock in the parliament. Looking forward, the ongoing modernization of commercial life and the opening of the economy to the outside world will likely lead to a gradual, if uneven, adoption of economic reform.

#### Ukraine and Energy

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¶7. (SBU) The geopolitics and economics of energy continue to play a central role in Ukraine. Energy consumption per capita remains the highest in the world, and the energy infrastructure is decaying. Ukraine remains heavily dependent on gas and oil imports from Russia and Central Asia, and is the main transit country for Russian gas shipments to central and western Europe. Nominal import prices for gas have increased almost fourfold in the past three years, and Russia has signaled it wants to eventually move to price levels charged to Western European customers. Most Ukrainian policymakers agree that Ukraine must diversify its sources of energy and move towards a market-based energy relationship with Russia, but Kyiv has yet to develop a long-term strategy to achieve these goals.

¶8. (SBU) The USG has encouraged Ukraine to open its energy market to more foreign investment. Few Ukrainian energy companies have the technical and financial resources to bring domestic production up to potential. Houston-based Vanco in

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October 2007 signed Ukraine's first-ever production sharing agreement (PSA) for oil and gas exploration in the Black Sea.

In May of this year, however, the GOU annulled the PSA, citing specious reasons. Ukraine's already poor investment climate image is likely to worsen if the GOU fails to reinstate Vanco's permit (reftel). There are some bright spots, however. Within the framework of the USG-supported Nuclear Fuels Qualification Project, Westinghouse has signed a contract to supply Ukrainian reactors with fuel starting in ¶2011. This will help Ukraine diversify its sources of fuels for its nuclear power plants, all of which currently get their fuel from Russia. New Jersey-based Holtec in September signed a \$250 million deal to build a spent nuclear fuel storage facility at the Chornobyl Nuclear Power Plant. Forces within the Ukrainian energy establishment, likely acting at the behest of Russian interests, had been trying to torpedo these projects. These projects' success, or lack thereof, will be important signals whether Ukraine has the will to move towards more energy diversity in the face of Russian geopolitical and economic interests.

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